Current Advertiser Practices in Compensating Their Advertising Agencies

A report based on 263 compensation arrangements which were described by participants in a survey conducted during November-December 1982 by the ANA Advertising Financial Management Committee under the auspices of the Association's Advertising Management Policy Committee. The findings, classified by expenditure level and advertiser category, cover both media commission and fee arrangements. Detailed information on compensation practices with respect to 25 agency services and specialized functions, such as new product development work and cable advertising, is contained in the report. Also included as an appendix is an illustrative program for an agency financial audit.

SUMMARY REPORT OF SURVEY FINDINGS

1. **The traditional commission system is still the predominant form of agency compensation. However, the trend toward modifications of the commission system, or arrangements that are strictly fee, is continuing.**
Advertiser characterization of their agency compensation systems was measured in 1976 and 1979 as well as in the current study. Although a slightly different questioning approach was used in the two previous studies, the results are believed to be comparable. Fifty-two percent of reporting advertisers now use a media commission arrangement, while 29 percent report a fee arrangement and 19 percent use some variation of the traditional commission system. The use of the 15 percent commission arrangement has declined from 68 percent in 1976 and 57 percent in 1979. There have been corresponding increases over the years in fee compensation arrangements and variants of the traditional commission arrangement.

Association of National Advertisers, Inc.
155 East 44th Street, New York, NY 10017
212-697-5950

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	1982 %	1979 %	1976 %
Media commission arrangement	52	57	68
Variations of the traditional 15 percent commission*	19		
Fee arrangements in which commissions are a factor**		18	15
Total of commission and commission related arrangements	71%	75%	83%
Strictly Fee (media commissions are not a factor)	29	25	17
	100%	100%	100%

*1982 question; **1979 and 1976 question.

The kind of compensation arrangement an advertiser uses depends on the nature of his business and the size of his advertising appropriation. Consumer goods advertisers (package goods and durables) are more likely to use the traditional commission or some variation of it, while business-to-business advertisers are more likely to use fees.

The larger the advertiser, the less likely he is to use a fee.

	Under $5 Million	$5-9 Million	$10-19 Million	$20-49 Million	$50 million and over
Use fee	38%	29%	21%	25%	19%

Also, larger advertisers are less likely than smaller advertisers to use a straight commission and more likely to use a variation of the commission system.

	Under $5 Million	$5-9 Million	$10-19 Million	$20-49 Million	$50 million and over
15% commission	44%	65%	67%	48%	42%
Variation of 15% commission	18%	6%	12%	27%	39%

2. **About one in four advertisers made a change in compensation arrangements in the past three years. Some of these changes resulted in an increase in agency compensation (8%); some in a reduction in agency compensation (9%). In 7% of the cases the change resulted in no significant difference in agency compensation.**

Twenty-one fee advertisers reported a change in their compensation arrangements in the past three years. Of the 18 who indicated the effect on the agency's compensation, one reported that it increased, 10 that it declined and 7 said there was no change.

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Of the forty-five commission advertisers who reported a change in their compensation methods, 41 indicated the effect on agency compensation. In 19 cases, it increased, in 12 cases there was a decrease, and 10 reported no change.

The specific reason for a change in compensation practice clearly depends upon the total relationship between the advertiser and the agency. In general, however, it appears that there are three reasons for such changes:

a. There is a change in advertiser service requirements and a clear need to increase or decrease agency compensation because of it.

b. The agency profit on the account has been demonstrated by the agency to be inadequate or nonexistent.

c. The advertiser believes that he is paying too much for the agency service that he receives.

3. More clients are receiving television and research services at no additional charge other than the out-of-pocket outlays that may be involved. A comparison for those services which were included in all three studies in which this trend is evident follows:

	Commission Covers— No extra charge other than out-of-pocket		
Nature of Service	**1982 %**	**1979 %**	**1976 %**
Agency videotape facilities used when auditioning talent	67	47	—
Union pension & welfare payments when handled by agency	50	38	—
Purchase of packaged shows	44	28	17
Rights to broadcast events & shows	46	36	31
Development of shows	35	33	33
Travel expenses of agency personnel to supervise production	88	85	76
Creative concept-testing, development	75	55	47
Alternate copy testing	52	50	44
Finished commercial testing	45	43	24
This was not the case for the following two services.			
Rough storyboards	81	81	83
Finished storyboards prepared by agency	55	60	22

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4. **About three out of four commission advertisers accept a 17.65 percent markup on production costs, and most others permit a 15 percent markup on production costs.**

Seventy-three percent of all advertisers accept the 17.65 percent markup. Package goods advertisers (68%) and, especially, package goods advertisers with appropriations over $50 million (53%) are less likely to accept the 17.65 percent markup on production costs.

5. **The majority of commission advertisers pay extra for agency new product work.**

About three out of four commission advertisers reported a special and distinct reimbursement arrangement for new product work, while the balance expected the agency to absorb new product development expense from the ongoing flow of commissions.

Among the advertisers who do make payment for new product costs, 19 percent reimbursed out-of-pocket costs only, or marked up out-of-pocket costs; one third negotiated a separate fee for each new product assignment; and 21 percent guaranteed agency expense and a fair profit on new products within the context of the prevailing commission compensation arrangement.

6. **Two-thirds of all advertisers periodically review the profitability of their account with their agencies.**

In 1979, 56 percent of all advertisers reported a periodic review of the profitability of their account with their agencies. The 1982 level of 66 percent suggests a trend toward such reviews. Commission advertisers are somewhat less likely (63%) to review acount profitability data with their agencies than are fee advertisers (73%).

7. **Most fee advertisers calculate the difference between the fee they pay and traditional commissions their account would generate. In about two-thirds of the reported cases the actual fee is less than the earned commission.**

Eighty-three percent of fee advertisers reported making such a comparative calculation. In 53 percent of the cases the fee is lower, and in 25 percent of the cases it is higher.

Consumer package goods and durables advertisers are more likely to find that their fees are lower than earned commissions than are other advertisers. In addition, the larger the advertising appropriation under a fee, the greater the likelihood that the fee will be lower than earned commissions.

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	Under $5 Million	$5-9 Million	$10-19 Million	$20-49 Million	$50 million and over
Fee is lower than earned commissions.	33%	50%	56%	92%	86%

8. **Three quarters of all advertisers have a formal procedure for auditing agency charges and procedures.**
   Fee advertisers are somewhat more likely (81%) to have such formal audit procedures than are commission advertisers (73%).

9. **Fifty-nine percent of all advertisers reported that they had a formal procedure for evaluating overall agency performance.**
   This appears to be a slight increase over the level reported in 1979 (54%), although the question forms are not totally comparable in the two studies.

   Fee advertisers are more likely, in 1982, to have such reviews (68%) than are commission advertisers (55%).

10. **Forty-five percent of the reporting companies reported cable television usage. Most companies (29%) who use cable expect to spend less than $500,000 in the medium in 1983. And only 4 percent of the reporting companies expect to spend more than $2,000,000 in cable television in 1983.**
    The questions about cable television advertising are new to this 1982 study. As might be expected, there is a higher incidence of cable television usage among consumer goods (package and durables) advertisers than among other advertisers. Also, the larger an advertiser's appropriation, the more likely he is to use cable.

A Word of Caution

The unique character of this survey response requires a word of caution. The companies represented in this study are among the major advertisers in each product or service category. These companies almost always retain one or more major advertising agencies. The compensation arrangements of these ANA members may not, therefore, be representative of the compensation arrangements of all companies that advertise. The premise upon which this report and its predecessors has been based is that it is important to know how major companies compensate their agencies.

As in all mail questionnaire studies of complex business practices administered in a variety of ways, it is not at all certain that individual respondents interpreted the questions in this study in a uniform way. If some of the detailed responses seem to the reader to be ambiguous or inconsistent with his own professional training or experience, the possibility of inconsistent question interpretation should be borne in mind.

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